Attachment 1

WILSHIRE
CONSULTING

Rosalind M. Hewsenian
Managing Director

May 3, 2006

Ms. Anne Stausboll
Interim Chief Investment Officer
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Internal Alpha Portfolio Recommendation

Dear Anne,

You had requested Wilshire's opinion with respect to Staff's recommendation to initiate a pilot program to enhance the return of the currency overlay program through an actively-managed internal portfolio. Wilshire concurs with Staff's recommendation.

Discussion

Staff has been in discussions with Wilshire for two years about the merits of initiating an internal actively-managed currency overlay portfolio. During that time Wilshire raised a number of issues for Staff to address in its approach to implementing this type of strategy so that Staff could address them early on. These include factors such as rationale and investment philosophy, strategy parameters, risk levels, performance objectives and resource needs. Wilshire as a firm has long held that there is no long-term return to currency, thus it does not constitute an asset class. Staff's recommendation and Wilshire's' concurrence does not change that position. However, in the short-term there are opportunities to earn a positive rate of return through currency management because there are many non-economic traders of currency:

- Central banks, trying to manage currency reserve levels
- Hedgers, trying to mitigate currency risk
- Businesses and individuals translating currency for non-investment purposes.

These non-economic market participants can create short-term distortions in valuation that can be exploited for investment gain.

Staff and Wilshire have canvassed the active currency management strategies and they distill to four:

- Fundamental
- Technical
- Interest Rate
- Dynamic Hedging.

Like all active strategies that are stringently followed, these can go in and out of favor. Staff's concern about simply hiring outside managers is that each manager sticks to one strategy only.

Staff's objective is to combine these strategies to capture their alpha producing capabilities and mitigate the downside risk through the diversification benefit. To accomplish this goal, Staff intends to build and test quantitative decision-making models, one for each strategy, to determine the active currency positions. In doing so, Staff wants to achieve its active return with a degree of risk control a single strategy manager may not accomplish.

To implement Staff is seeking to incur greater tracking error (the risk of active management) around the stated benchmark, the 100% hedged currency benchmark, to achieve a modest amount of value added. Staff's goal has been expressed in terms of a range of information ratios (the ratio of the value-added return over the variability of that return, or risk level): 0.3 to0.75%, which Wilshire considers a reasonable range. Once the models have been developed and tested, a more precise performance objective can be determined.

Currently, Staff manages internally a passive currency overlay strategy, which means its performance objective is not to add value, but is solely to manage risk, or be 100% hedged. By varying the hedge ratio, tracking error will be increased in an effort to achieve value-added. Staff has already demonstrated an ability to add value, 0.43% cummulatively since the inception of the internally-managed currency overlay portfolio, through careful implementation and trading. This value-added was achieved by taking advantage of currency mis-pricing in the market as Staff looked to execute its trades.

Risks

Since this proposed strategy is still in development, it is difficult to quantify the risks. However, there are three that are worth noting. The first is absolute risk, or volatility. This risk may actually be reduced through extending the currency overlay strategy through active management because it may result in a lower overall allocation to non-US dollar exposure, which is already a source of absolute risk in the CalPERS Investment Program.

The second risk is relative risk, or the risk relative to the benchmark. This is also called tracking error, which is caused by active management. This risk will increase. It has to in order to achieve the excess return over the benchmark. This risk can be monitored and tightly controlled to an acceptable level to fall within the proposed information ratio range, especially through the use of a quantitative model-driven implementation approach.

The final risk is the management of cash flow that comes from settling the currency forward contracts necessary to implement any currency overlay strategy. CalPERS has incurred this risk since the inception of its currency overlay program. Staff is adept at managing this risk through the netting of positions so that the in-flow from one position can be used to offset the required out-flow of another position without disturbing the corpus of CalPERS' assets. With a net positive rate of return, the cash flow risk of the internal currency overlay program has been positive thus far. However, as with any active strategy under-performance can happen, and probability will for some period of time, which shall increase the cash flow risk. CalPERS has a weekly internal meeting to manage the overall cash needs of the System. Therefore, the implications of active currency overlay on cash flow shall be addressed in these weekly meetings. However, at the initial levels that Staff is seeking, the cash impact of approving this pilot program is di minimus.

Resources

Data needs, staffing needs and systems needs for developing this pilot program at this point are adequate so there are no incremental resource needs to be addressed. Staff has also forged several strategic relationships with other market participants like banks and asset managers that have provided insight into the development of this investment concept. Leveraging these relationships has contributed to Staff's knowledge and research base.

Next Steps

The next step is to prepare a policy amendment to be taken to the Investment Policy Sub-Committee meeting and then to develop the quantitative models. Wilshire shall continue to work with Staff to monitor the development of the models and to provide a posting to the Investment Committee before going live with actual trading in the new strategy.

Conclusion and Recommendation

Wilshire completed a review of the Internal Currency Management Unit, which has been provided to the Investment Committee in the Open Session Agenda Item #9(b).

Wilshire's review indicates that Staff has the depth of talent and resources to pursue the development of an active currency strategy. The Staff intends to build upon the knowledge and experience it has gained in the successful management of the passive strategy, to enhance it to achieve value-added. This is not unlike what all the major index fund managers have done, i.e. started out managing index funds and migrating to an enhanced strategy that seeks active return within a risk-controlled approach. Staff's recommendation is consistent with the Fixed Income Unit's annual plan. Staff intends to take a measured and risk-controlled approach to implementing an active currency management strategy.

Further, developing a capability internally to manage currency actively will leave CalPERS less vulnerable to a significant organizational change in one or more of its external currency overlay managers. Wilshire recommends that the Investment Committee approve this pilot program.

Should you have any questions or require anything further, please to not hesitate to contact us.

Sincerely,